NATIONAL FORECAST DESCRIPTION
The Forecast Period is the Fourth Quarter of 1998 to the Fourth Quarter of 2002

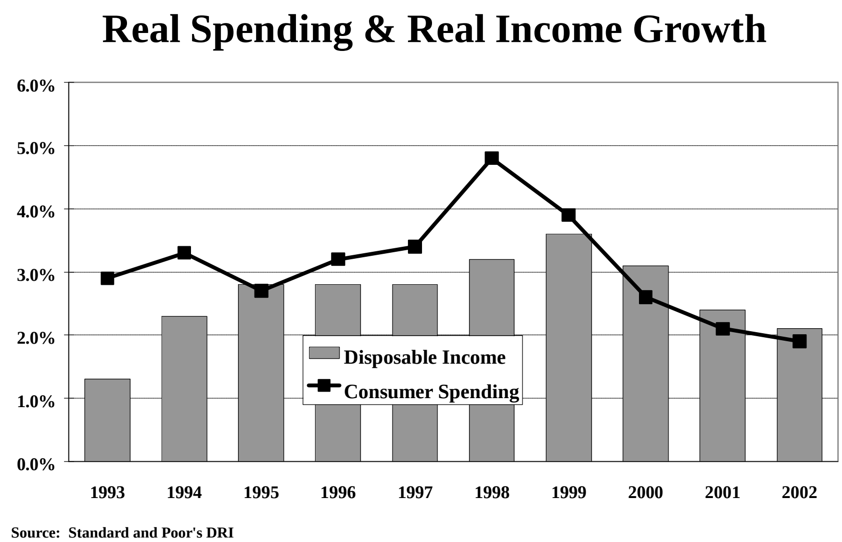
The U.S. economy celebrated its eighth straight year of growth this month. While this is very young in human years, it is old on an economic scale. On average, U.S. economic expansions have lasted just under four years. Not only has this expansion lasted twice as long, it is fast approaching the record of 106 months that occurred from February 1961 to December 1969. Interestingly, at the age where most expansions are winding down, this one has actually become more vigorous. For example, real GDP grew at a 3.7% annual rate in the third quarter of 1998 followed by an astounding 6.1% in the fourth quarter. Despite this strength, the economy still hasn't developed any of the ailments that would indicate it is near the end of its expansion. Two symptoms absent are high inflation and high manufacturers' capacity utilization rates. A look at both of these suggests no imminent problems. Consumer prices, thanks to soft food prices and the collapse in oil prices, rose just 1.6% last year and remains under control. Likewise, the manufacturers' capacity utilization rate is safely below the critical level. After this positive check up, many experts have revised their prognosis for the national economy. In its November 1998 macroeconomic forecast, DRI projected that real GDP growth would slow to 1.7% in 1999. Four months later, it now projects that real GDP will grow 3.7% this year.

At this point it would be tempting to conclude that the economy has discovered a fountain of youth of sorts. However, this is not likely to be true. Although there are no imminent storm clouds on the horizon, this expansion, like previous ones, remains vulnerable to the imbalances that have doomed its predecessors. While it is impossible to determine what form this calamity will take, one can speculate. For example, surging consumer confidence boosted consumer spending in recent years. It would be interesting to see what would happen if for some reason consumer confidence began to retreat. This is explored in the *Alternative Section* of this forecast. It is interesting to note that in both alternative scenarios the U.S. economy slips into a recession. A more detailed description of these alternative forecasts and their impacts on the Idaho economy can be found in the *Alternative Section* of this forecast.

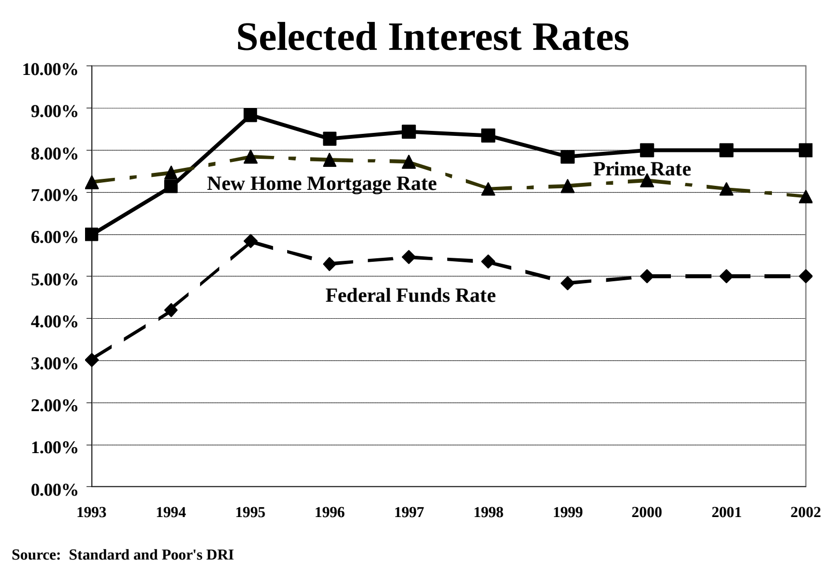
It is important to note that the economy is not expected to suffer a recession over the forecast period. Under its baseline (most likely scenario), DRI expects the U.S. economy to continue growing, albeit at a slower pace, over the forecast period. Specifically, real GDP is forecast to rise 3.7% this year, 2.1% next year, 2.4% in 2001, and 2.0% in 2002. As was the case in 1998, no significant imbalances are anticipated during the forecast period. Inflation will creep up, but remain low. The U.S. manufacturing capacity rate should stay under the level associated with inflation. Unemployment will also rise, but it will remain below the full-employment rate. If DRI's current forecast holds, Americans will enjoy the fruits of the longest modern economic expansion on record.

SELECTED NATIONAL ECONOMIC INDICATORS

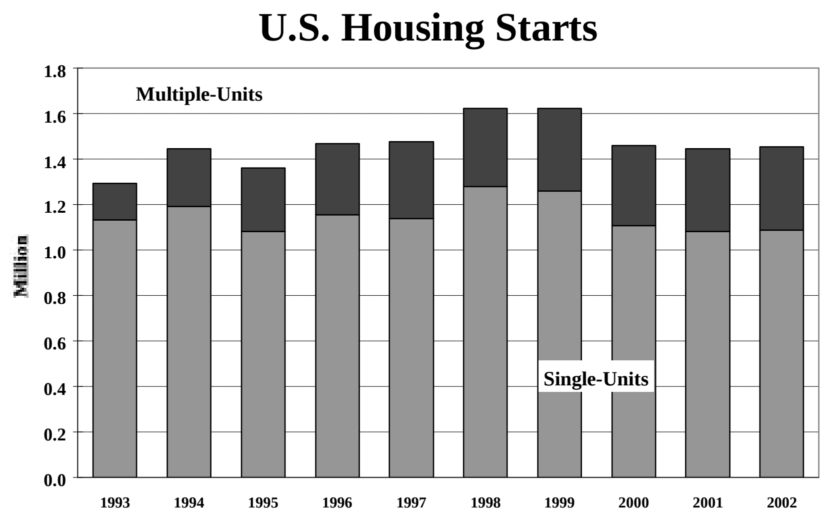
Consumer Spending: Consumer spending has been a major contributor to the economy's overall growth in the last two years. For example, real consumer spending growth was 3.4% in 1997, just one-half percentage point less than the 3.9% growth rate for real GDP that same year. In 1998, real consumer spending actually led real GDP growth by a wide margin, 4.8% versus 3.9%. Not surprisingly, real spending, which typically accounts for about two-thirds of the economic activity, climbed to 68.2% of real GDP in 1998. Consumers were able to achieve this pace, despite modest income growth, by dipping into their savings and taking on more debt. A review of disposable personal income shows that it did not grow fast enough in 1997 and 1998 to support the level of spending in those two years. To make up this gap, consumers turned to savings and debt. The personal savings rate, which had been nearly 6.0% in 1992, had fallen to virtually zero in 1998. The amount of outstanding consumer credit (which does not include mortgages or auto leases) grew 6.1% in 1998, up from its 4.8% pace in 1997. This seemingly extravagant behavior is due primarily to extremely high consumer confidence. A look at several factors suggests that much of this confidence can be justified because the economy is the healthiest it has been in recent memory. The unemployment rate is low. Inflation is low. Interest rates are favorable. The stock market is high. And the net worth of households has grown by leaps and bounds. Thus, for many Americans these days are indeed the "best of times," and their spending habits reflect it. The question is whether consumer spending can maintain this pace. The short answer is not likely. This is because the factors that boosted consumer confidence should start to reverse. Rising exports will start to cost American jobs, so that by 2002 the civilian unemployment rate should be back above 5.0%. The consumer inflation rate is expected to creep up to 2.4% by 2002. The stock market probably has one more year of double-digit growth (13.2%) in 1999 before it slips to annual growth below 5.0% beginning in 2000. This will also cause household net worth growth to slow. As a result, consumer confidence is expected to slip and real consumer spending should grow more in line with real disposable income over the forecast period. Specifically, real consumer spending growth should be 3.9% in 1999, 2.6% in 2000, 2.1% in 2001, and 1.9% in 2002. Real disposable income is expected to rise 3.6% in 1999, 3.1% in 2000, 2.4% in 2001, and 2.1% in 2002.



Financial: At times the work of the Federal Reserve resembles the military: long stretches of boredom broken up by moments of sheer terror. The fall of 1998 is an example. After months of inaction, the nation's central bank made three quick moves to lower interest rates when it appeared the U.S. economy was threatened by economic problems abroad. These moves helped to ease fears and helped the U.S. economy put in an especially strong showing at the end of 1998. It now appears that the Federal Reserve has entered a period when little action is expected. This does not mean the Federal Reserve is sitting back as the economy cruises on autopilot. The nation's central bank is expected to take a "wait and see" course while it continues its vigilant watch



over the economy. No action is expected until later this year. There is no need for the Federal Reserve to tighten because inflation is not a problem. However, inflation should creep up later this year, and this should cause the Federal Reserve to raise interest rates a notch in the second half of this year. This round of tightening is projected to continue over the next year. The federal funds rate should climb to 5.0% in 2000 and remain there through 2002. The stock market surged again in March. DRI is projecting more moderate stock market gains over the next five years.

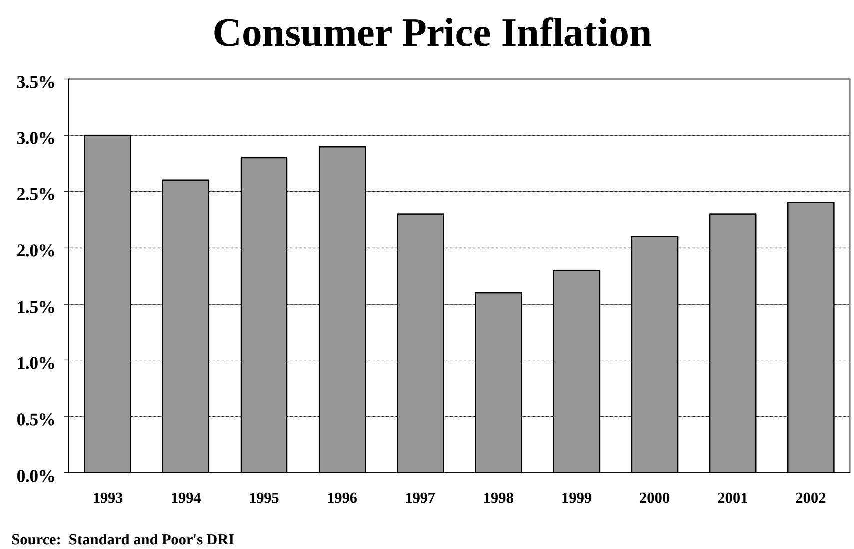


Source: Standard and Poor's DRI

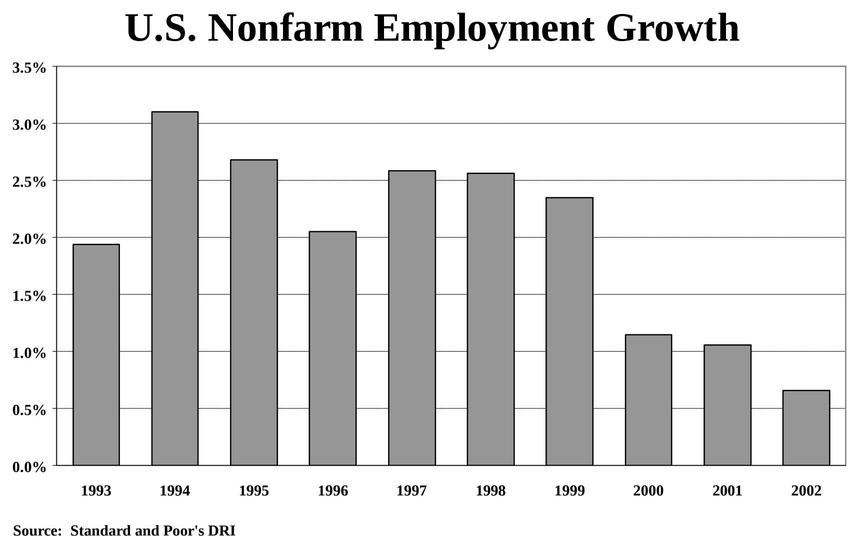
Housing: Plentiful jobs, the lowest mortgage interest rates since the 1970s, and the booming stock market all helped make last year one of the most memorable ones for the U.S. housing industry. Housing starts topped 1.6 million units in 1998, their strongest showing since 1987. Other measures also testify to this sector's health. Sales of new single-family homes increased by nearly 100,000 units from 1997 to 1998. Existing home sales mirrored this performance. There were over one-half million more existing single-family homes sold in 1998 than in 1997. Not surprisingly, real construction spending rose over 10% over the same period. Like consumer spending, the housing sector is expected to fare better over the next few years in this forecast compared to the previous one. In the January 1999 *Idaho Economic Forecast* it was projected that national housing starts would fall to about 1.5 million units in 1999. In this *Forecast*, U.S. housing starts hold at 1.6 million units in 1999. However, they do decline in 2000, as the slowing economy takes its toll on consumer confidence. <u>National housing starts are anticipated to be 1.62 million units in 1999, then hover around 1.5 millions units annually thereafter.</u>

Source: Standard & Poor's DRI

International: This section reviews real export growth prospects for the U.S. over the forecast period. Of course this is tied directly to the outlooks for our major trading partners. The good news is that Asia promises to be less of a drag on the U.S. economy this year than it was last year. The Korean, Thai, and Philippine economies have all apparently turned the corner back to growth. Japan, however, remains mired in recession. It is not expected to return to prosperity until it undertakes meaningful bank reform. Closer to home, Central and South America are expected to be a drag on exports, as the impacts of the collapsing Brazilian real infect the region. Argentina will be particularly hard hit because its dollar-pegged currency is pricing it out of Brazil, its most important market. U.S. trade with Latin America (excluding Mexico) is not huge, so the downturns there are unlikely to have as dramatic an impact as the Asian collapse. Mexico should remain relatively unscathed by Brazil's problems. This is because Mexico's trade is focused northward more than southward, so it will benefit from the relatively strong U.S. economy. At our nation's northern border, Canada has shown incredible resilience to soft commodity prices. Like the U.S., robust consumer spending has kept the Canadian economy moving forward. However, a dearth of investment in the commodity sector plus more subdued consumer spending should dampen Canadian growth in 1999. But recovering global demand and firming commodity prices should fuel faster growth in 2000. Europe is a little worrisome. While it has been the second strongest economy behind the U.S., there are signs that European growth is slowing. All three major continental economies (Germany, Italy, and France) have suffered from declining export orders and low investment. There has been some pressure for the European Central Bank (ECB) to lower rates to fix this problem. But the ECB loathes such a move for two reasons. First, this new central bank is determined to prove its independence to the financial world. Second, the central bank is concerned that the newly minted euro will fall further against the dollar, especially if the Federal Reserve raises interest rates later this year. Prospects are a little more promising across the English Channel. (The UK does not belong to the European Union.) In the United Kingdom, the slide in manufacturing activity seems to be nearing an end, following interest rate cuts totaling 200 basis points and sterling's 6% slide against the dollar. Real net exports are expected to worsen before they improve. Specifically, U.S. real net exports (NIPA basis) should be -\$303.6 billion in 1999, -\$308.1 billion in 2000, -\$306.2 billion in 2001, and -\$302.2 billion in 2002.



Inflation: Consumer prices rose just 1.6% in 1998, despite the economy's red-hot performance. The last time prices increased by less than 2.0% was in 1986. One of the main factors behind 1986's low inflation also helped keep down prices last year. That factor was the drop in energy prices. In 1986, the collapse in oil prices caused the energy component of the consumer price index (CPI) to drop 13.2%. Over the last two years the price of oil has nearly halved. As a result, energy prices were virtually flat in 1997 and dropped by about 8% in 1998. Much of the weakness of oil prices reflects weak world demand due to the Asian economic crises and strong world supply caused by noncompliance among OPEC members. While there is a natural tendency for cartel members to cheat on agreed production levels, current financial problems in many oil-producing countries have made this an even bigger problem. But low energy prices were not the only thing keeping a lid on inflation. Weak farm prices continued to bedevil American farmers. After dropping 7.7% in 1997, producer-level prices for farm products dropped another 7.4% in 1998. This helped to keep the consumer food price index increase under 2.5% in 1998. Another factor holding inflation down is labor costs. Despite the tight labor market, compensation has been extremely well behaved. For example, the employment cost index for wage and salaries rose 4.0% last year and the cost of benefits increased just 2.5%. This is a reversal from the late 1980s and early 1990s when benefit costs, led by medical coverage increases, rose much faster than wages and salaries. The current situation partially reflects the cost savings of switching from traditional health care plans to health maintenance organizations. Once this conversion is complete, benefit costs are expected to once again rise faster than wages and salaries. This will put upward pressure on inflation. In addition, energy and food prices are forecast to recover over the forecast period, which will also cause inflation to inch up over the next few years. <u>The consumer price index is expected to rise 1.8% in 1999, 2.1% in 2000, 2.3% in 2001, and 2.4% in 2002.</u>



Employment: Thanks to the improved outlook for the national economy, the projected slowdown in U.S. nonfarm employment growth has been postponed from 1999 to 2000. In the January 1999 *Idaho Economic Forecast* it was reported that U.S. nonfarm employment would grow just 1.3% in 1999. In the current forecast, nonfarm employment is now projected to advance 2.3%—a full percentage point faster. In addition, the 1999 civilian unemployment rate is lower in this forecast than in the previous one, 4.3% versus 4.9%. (Despite the stronger job market, consumer inflation is just 1.8% in 1999 compared to the previous forecast's 2.4% rate for the same year. In fact, inflation is lower throughout the forecast period.) The employment slowdown may have been delayed, but it has not been eliminated. In both 2000 and 2001, nonfarm employment will slow to 1.1%. The civilian unemployment rate should also creep up, going from 4.3% this year to 5.1% in 2002. It is helpful to review which sectors will account for job growth in the near future. For all practical purposes, the service-producing sector is now the nation's job market. Manufacturing employment as a share of total nonfarm jobs has shrunk to 15%, while service-producing employment has grown to 80%, with mining and construction accounting for the remainder. Although manufacturing output should continue to grow, productivity gains will reduce the need for more workers. By 2003, manufacturing will account for just 13% of all jobs. Service jobs are expected to fill the void left by disappearing assembly line jobs.

Business Investment: Business investment has contributed more to this expansion than to any of the country's nine expansions following World War II. Indeed, one-fourth of the total GDP growth since 1991 has come from business investment, which is much larger than the average 15% share for the previous eight expansions. This investment has mainly occurred in producers' durable equipment. Over the past five years, equipment investment has averaged 10.3% annual gains. This boom in producers' durable equipment is due to four factors: falling computer prices, strong profits, favorable credit conditions, and competition. Businesses have taken advantage of falling computer prices in recent years; this is the main reason the office machinery component of equipment has averaged 46% annual growth over the past four years. Rising profits have generated much of the cash necessary to fuel the expansion of equipment. Profits have accounted for nearly 8% of GNP during this recession compared with 6.0% in the last expansion. Since internally generated funds are less expensive than borrowed funds, this has bolstered investment. This is not to say that borrowing has been unattractive. To the contrary, shrinking federal government deficits and now-growing surpluses have freed up capital for the private sector. In addition, the Asian financial crisis has caused a flood of foreign funds into the U.S. Of course, businesses would be foolish to make investments in equipment, no matter how favorable the terms, if economic activity did not warrant these investments. However, current conditions do call for these investments. Facing intense competition both at home and abroad, U.S. businesses realize they must continue to increase their productivity to survive. Computers and other office equipment are the most cost-effective ways to raise productivity. This increased productivity has helped the economy maintain low unemployment without setting off inflation. Unlike the beginning of 1998, excess inventory build up does not appear to be a problem. During 1999, inventory building associated with Y2K planning should provide a small boost to the economy, before turning neutral in 2000, when those stocks built as a buffer against disruptions are liquidated. One of the reasons this inventory building will have just a slight impact on the economy is because most of the products stockpiled will likely be imported goods. This reflects the feeling that other countries are less prepared for Y2K than the U.S. The strong growth rates of the recent past should prove unattainable over the forecast period. For example, after rising nearly 12% last year, real business investment is forecast to rise 8.4% this year, 4.9% next year, 4.4% in 2001, and 4.0% in 2002.